11-2018

What are Some Best Practices for Managing Long-Term Incentive Plans (LTIP) during M&A Activity and What Impact Do LTIPs Have On Employees?

Mikaila McAndrew
Cornell University

Blake White
Cornell University

What are Some Best Practices for Managing Long-Term Incentive Plans (LTIP) during M&A Activity and What Impact Do LTIPs Have On Employees?

Abstract

[Excerpt] In 2017, companies announced over 50,600 M&A transactions with a total value of over $3.5 trillion. Approximately 80% of these M&A deals fail for a variety of reasons: culture differences, stark operational differences, and budget constraints. Due to the nature of M&A activity, employee LTIPs – which are often made up of stock options, RSUs, and other forms of equity – are the most affected form of compensation during this process. HR and other business leaders should adhere to best practices and due diligence concerning LTIPs to prevent their firm merger, acquisition, or spin-off from becoming another statistic.

Keywords

human resources, M&A, mergers, acquisitions, long-term incentive plans, stock options, equity, LTIP, cash method, conversion method, portfolio approach, dividend approach, short-term incentives, business strategy, performance management

Comments

Mikaila McAndrew
Blake White

EXECUTIVE SUMMARY

November 2018

RESEARCH QUESTION

What are some best practices for managing long-term incentive plans (LTIP) during M&A activity and what impact do LTIPs have on employees?

INTRODUCTION

In 2017, companies announced over 50,600 M&A transactions with a total value of over $3.5 trillion. Approximately 80% of these M&A deals fail for a variety of reasons: culture differences, stark operational differences, and budget constraints. Due to the nature of M&A activity, employee LTIPs – which are often made up of stock options, RSUs, and other forms of equity – are the most affected form of compensation during this process. HR and other business leaders should adhere to best practices and due diligence concerning LTIPs to prevent their firm merger, acquisition, or spin-off from becoming another statistic.

BEST PRACTICES

There are a variety of ways to manage LTIPs during the M&A process. How a company approaches stock options, RSUs, and share translation depends strongly on the structure of the deal taking place, the employee composition of each firm, and the goals of senior leadership.

There are three key methods for handling stock options during an M&A transition period: **Assumption**, Stock options remain in place, but the number of shares and exercise price are adjusted to reflect the transaction. **Substitution**, Old options are canceled and new options are issued under the acquirer's plan. The acquirer's shares used for option exercises are charged against the acquirer's equity plan reserve. **Cash Method**, Old options are cancelled and payment is made in cash or stock of the acquirer. Amount of cash out is equal to intrinsic value of the option at closing of transaction. Similarly for RSUs, there is the **Cash Method** and the **Conversion Method**. These methods follow an identical structure to those mentioned for RSUs.[1]

For company spin-offs, there are multiple ways to approach share distribution. The three most commonly used methods are: **Portfolio approach**, Equity holdings are treated like those of a shareholder at the time of the spin (e.g. equity will be translated to both remaining firm's equity and the new firm's equity). **Concentration approach**, Employee's current equity is translated into one firm's equity alone depending on where the employee resides. **Dividend approach**, This is the most nuanced option of the three and allows the employee to have a choice in how options and other equity are managed (See Appendix A).[2]

IMPACT

Although the effectiveness of long-term incentive plans on employee and organizational outcomes is inconclusive, there is growing evidence that LTIPs are actually ineffective. Many companies who implement LTIPs into their business strategy believe that these types of incentives create an ownership mindset for their employees.[3] As a result, these employees will be held accountable for their performance since their LTIP is linked to company profits. However, pay for performance can negatively impact an employee's intrinsic motivation. Executives receiving an LTIP from one company stated that they would be willing to reduce their pay package by an average 28% for a job that was more rewarding for non-monetary reasons.[4] Large pay packages also do not correlate with better performance on the job. Therefore, performance cannot be improved simply through monetary incentives like an LTIP. Companies are realizing this issue, and some have decided to move from LTIPs to annual cash bonuses. Some firms have considered making it a requirement to invest part of the bonus in restricted stock, so that executives still own equity of the company without the confusion or inefficiencies of a LTIP. These short-term incentives have been regarded by both executives and non-executives as much more effective than long term incentives. The short-term incentives have a clearer line of sight between action and reward whereas long term incentives failed to do so and were too complex and easily misunderstood.[5]

Even though there isn't a conclusive answer on the impact of LTIPs on employee and organizational outcomes, companies should consider how they are planning to use these incentives. Companies should use short term rewards in order to improve employee engagement and motivation. If LTIPs align with the overall business strategy of the company, then leaders should consider simplifying the plan to make it as easily understandable and transparent to employees as possible. That way, employees know exactly what they are being rewarded for and how much they are benefiting from the plan in the long run.

CONCLUSION

Once a company decides to acquire another company or spin-off part of the company into its own entity, leaders need to decide how long term incentive plans for executives will change. Before these leaders make a decision, a company should consider all approaches to LTIPs and determine which one best aligns with the business strategy and future vision of the new company. In addition, leaders should understand that the plan they decide on could also influence the work performance and motivation of their employees. By understanding how incentives seem to play into these factors, leaders can create a LTIP that successfully aligns with the new business strategy without disturbing the current employees' engagement in the workplace.

REFERENCES

1. "M&A Basics: Equity Compensation Plans." *Morgan Lewis*, Morgan, Lewis & Bockius, LLC, www.morganlewis.com/~/media/files/publication/presentation/webinar/eb_mabasicSequitycompensationplans_26feb151.ashx.

2. Gorski, Michael. "How to Deal with Equity Holdings During a Spin-Off." *WorldatWork*, WorldatWork, Dec. 2016.

3. Gibson, Ken. "Why Every Company Should Have a Long-Term Incentive Plan (LTIP)." *The 4 Parts of a Competitive Pay Strategy*, 18 Oct. 2016, blog.vladvisors.com/blog/why-every-company-should-have-a-long-term-incentive-plan-ltip.

4. "The Case against Long-Term Incentive Plans." *Harvard Business Review*, vol. 94, no. 10, Oct. 2016, pp. 22–23. *EBSCOhost*, search.ebscohost.com/login.aspx?direct=true&db=bth&AN=118307585&site=ehost-live.

5. Pepper, Alexander, Gore, Julie and Crossman, Alf (2013) Are long-term incentive plans an effective and efficient way of motivating senior executives? Human Resource Management Journal, 23 (1). pp. 36-51. ISSN 0954-5395

APPENDIX

Appendix A:

Illustrative Calculations for Shareholder and Employee Approach

The graphic below provides an example of how a company can translate pre-spin equity holdings into post-spin equity holdings for both restricted stock units and options using either the Shareholder or Employee Approach.

Assumptions for calculations:

- Pre-spin share price of $20 (and a 1-1 spin)
- Post-spin RemainCo share price of $15 and post-spin SpinCo share price of $5

Restricted Stock Units (RSUs)

Determine pre-spin value of RSUs (e.g., $20,000 in example below) to ensure a match after translation.

Shareholder Approach:

For each share of pre-spin equity held, provide one share of RemainCo and one share of SpinCo (i.e., 1,000 shares in each entity in example below).

Employee Approach:

Multiply the number of units by the ratio of (i) the pre-spin share price to (ii) the post-spin share price ($20 pre-spin/ $15 post-spin for RemainCo; $20 pre-spin/ $5 post-spin for SpinCo).

Stock Options

Determine pre-spin 'intrinsic value' of options (e.g., $37,500 in example below).

Shareholder Approach:

Similar to RSUs, participants will receive the same number of options in both RemainCo and SpinCo; the exercise price will be converted by multiplying the pre-spin exercise price by the ratio of (i) the post-spin share price to (ii) pre-spin share price ($15 post-spin/$20 pre-spin for RemainCo; $5 post-spin/$20 pre-spin for SpinCo).

Employee Approach:

Use the same exercise price conversion as in the Shareholder Approach and the post-spin share price to determine the spread per option ($15.000 less $9.375 for RemainCo employees, $5.000 less $3.125 for SpinCo employees). Then divide the pre-spin intrinsic value by the spread ($37,500 divided by $5.625 for RemainCo employees, $37,500 divided by $1.875) to determine the post-spin number of options.

Illustrative Translation Calculation
Based on assumptions above

	Restricted Stock Units			Stock Options		
	Current Holdings	(a) Shareholder Approach	(b) Employee Approach	*Current Holdings*	(a) Shareholder Approach	(b) Employee Approach
Pre-Spin Shares Held	*1,000*	--	--	*5,000*	--	--
Pre-Spin Value of Holdings	*$20,000*	--	--	*$37,500*	--	--
Pre-Spin Exercise Price	--	--	--	*$12.50*	--	--
RemainCo Employee						
Post-Spin RemainCo Shares	--	1,000	1,333	--	5,000	6,667
Post-Spin RemainCo Value	--	$15,000	$20,000	--	$28,125	$37,500
Post-Spin Exercise Price	--	--	--	--	$9.375	$9.375
Post-Spin SpinCo Shares	--	1,000	--	--	5,000	--
Post-Spin SpinCo Value	--	$5,000	--	--	$9,375	--
Post-Spin Exercise Price	--	--	--	--	$3.125	--
SpinCo Employee						
Post-Spin RemainCo Shares	--	1,000	--	--	5,000	--
Post-Spin RemainCo Value	--	$15,000	--	--	$28,125	--
Post-Spin Exercise Price	--	--	--	--	$9.375	--
Post-Spin SpinCo Shares	--	1,000	4,000	--	5,000	20,000
Post-Spin SpinCo Value	--	$5,000	$20,000	--	$9,375	$37,500
Post-Spin Exercise Price	--	--	--	--	$3.125	$3.125